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IN THE

Supreme Court of the United States

OCTOBER TERM, 1946.

No. 501

THE OKONITE COMPANY, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

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To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioner, The Okonite Company, prays that a writ of certiorari issue to the United States Circuit Court of Appeals for the Third Circuit, which affirmed the decision of the Tax Court sustaining the respondent in holding petitioner liable for additional Federal undistributed-profits tax for 1936 by reason of the disallowance to petitioner of a dividend-paid credit on account of dividends paid to the holders of old 7% preferred stock of the petitioner otherwise than in cash, namely, in new 6% preferred stock.

STATEMENT OF THE MATTER INVOLVED.

In 1936 the petitioner had a large number of stockholders (both common stockholders and holders of 7% preferred stock) and bond holders. The petitioner was then in arrears as to cumulative dividends upon the 7% preferred stock to the extent of $30. per share. Such accumulation of arrears of dividends on the preferred stock had the twofold result of prohibiting the petitioner from paying any dividends on its common stock and of according voting rights to the holders of the preferred stock, share for share with the common stock, as long as such arrears continued.

The petitioner had a large earned surplus and current earnings sufficient under state laws to justify a declaration of dividends on its common, as well as on its preferred stock, but did not have sufficient cash available for that purpose, first because of its obligations relative to its bonded indebtedness, and second because all available cash was required for the business purposes of the corporation. Nor was the petitioner able to borrow funds for the payment of dividends in cash.

Since no dividends could be paid to the common stockholders until the accumulated dividends on the 7% preferred stock had been paid, and since the latter could not be paid in cash (despite the large amount of earned surplus and current 1936 earnings), a resumption of dividend payments was possible only if the 7% preferred stock should accept some plan for the payment of its accumulated dividends in stock or in some form other than in cash.

In this state of the matter the petitioner devised a plan which had a twofold purpose; namely, the creation of a new issue of 6% preferred stock, part of which would be exchanged for old 7% preferred stock to the elimination of that issue, and part of which would be paid out as a stock dividend in payment of the accumulated dividends on the 7% preferred stock.

Pursuant to such plan a new issue of 6% preferred stock was authorized and created and a dividend of $30. per share was declared on the 7% preferred stock payable in the new 6% preferred stock. The whole plan contemplated the delivery of 6% preferred in the following amounts to all of the holders of the 7% preferred who should consent thereto:

> 1.15 shares of 6% preferred for each share of 7% preferred to equalize the difference in the respective dividend rates;
>
> .10 shares of 6% preferred for each share of 7% preferred to equalize the difference between the call rate of $115. per share, with respect to the 7% preferred, and of $105. per share, with respect to the 6% preferred;
>
> .3 shares of 6% preferred in payment of the declared dividend of $30. per share on the 7% preferred.

The plan was duly approved both by the common and the 7% preferred stock, almost all of the 7% preferred stock agreeing to accept 6% stock on the above basis in exchange for the 7% stock, and in payment of the accumulated dividends. The few 7% stockholders who did not so accept were paid their dividends in cash and their stock was called for redemption at the call price of $115. per share.

The Tax Court found, as a matter of fact, that the fair market value of the new 6% stock on the date of the delivery thereof to the 7% stockholders was $89. per share.

Earned surplus and current earnings were transferred by the petitioner to capital in the amount of the 6% preferred stock paid out in the form of stock dividends, and for the purpose of equalizing the difference between the call rate of the two classes of stock. The record shows the transfer of such earnings to the capital account.

The Tax Court held that the stock dividend so paid to the 7% preferred stock was not taxable income to the stockholders and therefore that the petitioner was not entitled to a dividend-paid credit with respect thereto. The Tax

Court thus apparently held that the transaction was a "recapitalization" and thus a non-taxable reorganization under §112 of the Internal Revenue Code.

The Circuit Court of Appeals for the Third Circuit affirmed the decision of the Tax Court. The petitioner contends that such affirmance was due to a misinterpretation by the Third Circuit of *Dobson* v. *Commissioner,* 320 U. S. 489.

Neither the Tax Court nor the Third Circuit attempted any definition of the term "recapitalization" as applicable to the instant transaction. That it was at least in part a recapitalization is not questioned, but the crucial question is whether it was a recapitalization in the crucial sense that it resulted in a "non-taxable reorganization" under § 112 of the Revenue Act of 1936.

At about the same time of its decision in the instant case, the Third Circuit decided the cases of *Bazley* v. *Commissioner* (now pending in this Court on a petition for a writ of certiorari as No. 287 for the October Term 1946), and *Adam* v. *Commissioner* (now pending in this Court on a petition for a writ of certiorari as No. 209 for the October Term 1946). In both of those cases the purpose of the transaction was deemed basic or crucial to the issue whether the transaction was a taxable or non-taxable reorganization; that is to say, if the purpose was primarily to benefit the stockholders, then the dividend though paid in stock would be taxable; but if the purpose was primarily for the benefit of the corporation, then the entire transaction would be a non-taxable reorganization.

In the case at bar the Tax Court made no finding whether the purpose of the plan was for the benefit of the stockholders or primarily for the benefit of the corporation, nor did the Tax Court or the Third Circuit comment, to any extent whatever, regarding the importance of the purpose as affecting the question of the taxability of the stock dividend.

Accordingly, there is a lack of consistency within the same circuit as to the legal principles involved in the case at bar and in the *Bazley* and *Adam* cases.

Actually there is nothing inherently difficult about a transaction, which could properly be called a recapitalization, being in part a recapitalization and in part a payment of dividends, nor is there anything inherently difficult about such a transaction being in part for the benefit of the corporation and in another distinct part being for the benefit of the stockholders. If the transaction in the instant case had varied only in that the dividends were paid in cash, the fact that the balance of the plan constituted a recapitalization (even though wholly for the benefit of the corporation) would not prevent the dividend from being taxable. Accordingly, whether the stock dividend is or is not taxable should depend on the nature of the dividend and not on the nature of the other features of the transaction. The same observation would be true as to the purposes of the transaction. The exchange of new 6% stock for old 7% stock may very well have been for the benefit of the corporation and in order to improve its financial picture. The payment of the stock dividend, however, was none the less primarily in the interest of the stockholders and not only merely in the interest of the 7% stock but at least equally in the interest of the common stock, because such payment of the accumulated arrears on the 7% stock enabled the corporation to resume dividends on the common stock.

JURISDICTION.

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925 (43 Stat. 938, Ch. 229, Sec. 1, U. S. Code Title 28, Section 347) and Section 1141 of the Internal Revenue Code.

The judgment of the Circuit Court of Appeals was entered April 18, 1946. By order of this Court the time for filing the petition for writ of certiorari was extended to September 15, 1946.

QUESTIONS PRESENTED.

1. Are the 7% stockholders who received a regularly declared dividend payable in the 6% stock to avoid an income tax thereon—with a corresponding denial of a dividend-paid credit to the corporation—merely because simultaneously or concurrently with the payment of such stock dividend the 7% stockholders exchanged their old stock for new 6% stock?

2. Is the aforesaid regularly declared stock dividend to be non-taxable to the recipients—with a corresponding denial of a dividend-paid credit to the corporation—merely by a characterization of the entire transaction (consisting of the declaration and payment of a dividend as well as the exchange of stock for stock) as a "recapitalization," despite the definition by the Supreme Court of the term "recapitalization" (*Helvering* v. *Southwest Consolidated Corporation,* 315 U. S. 194), as merely any "reshuffling of a capital structure within the framework of an existing corporation"?

3. Is the entire transaction consisting of two parts as aforesaid, a "recapitalization" in the sense that the regularly declared and paid stock dividend is non-taxable where the stockholders receiving the same thereby obtained a new and greater interest in the corporation than that previously possessed?

4. Where the directors of a corporation specifically declare a dividend on preferred stock, payable in preferred stock of the same corporation, but of a different issue, and in payment of accumulated arrears of dividends, and where the earned surplus against which such dividends are declared has been transferred to capital, and where the stockholders have accepted such stock dividend in payment of such accumulated arrears, does *Dobson* v. *Commissioner, supra,* or any other enunciation of principles by this Court endow the Tax Court with authority to disregard such evidence and to find as a fact that the aforesaid accumulated

arrears of dividends were thereby merely "eliminated" instead of being paid? Of course, the satisfaction of dividends in any form whatsoever, including payment in cash, is an "elimination" thereof in the sense that the obligation of the corporation with respect thereto is thereby discharged.

5. Is it essential to a determination whether the dividend payment feature of the transaction is taxable or non-taxable to the stockholders, to determine first whether the purpose of either the dividend feature of the transaction, or the transaction as a whole, was to benefit the stockholders or to benefit the corporation? If so, was it not the duty of the Tax Court to find as a fact, under the principles of *Dobson* v. *Commissioner, supra,* whether the purpose was to benefit the stockholders or the corporation? And was it not also the duty of the Third Circuit to review any such finding of fact or to make such finding if the Tax Court omitted to do so?

REASONS FOR ALLOWANCE OF THE WRIT.

I. This case involves important questions of Federal law which have not been but should be settled by this Court.

The decisions of this Court in *Koshland* v. *Helvering,* 298 U. S. 141, and *Helvering* v. *Gowran,* 302 U. S. 238, altered the entire concept of the taxation of stock dividends, as a result of which Congress amended the Revenue Laws in 1936, so as, for the future, to tax stock dividends under the conditions stated as follows in *Helvering* v. *Sprouse,* 318 U. S. 604, paraphrasing from the opinion in *Koshland* v. *Helvering, supra:*

> "To render the dividend taxable as income, there must be a change brought about by the issuance of shares as a dividend whereby the proportionate interest of the stockholder after the distribution was essentially different from his former interest."

In the case at bar the 7% stockholders received in payment of their accumulated dividends of $30 per share, .3 of a share of new 6% stock of a determined value of $89 per share. This new 6% stock, received in payment of accumulated arrears of dividends, unquestionably gave the recipient thereof a "proportionate interest" in the corporation "essentially different from his former interest."

The relative proportionate interests of both classes of stock, the 7% stock and the common stock, was essentially and materially changed by the event. The dividend so paid was charged against earned surplus and earned surplus in a corresponding amount was transferred to capital, thus increasing the interest of the 7% stock in the corporation at the expense of the common stockholders. Nevertheless, and in contravention of *Helvering* v. *Sprouse* and *Koshland* v. *Helvering, supra,* the Tax Court and the Third Circuit held that the dividend was not taxable because the transaction constituted a "recapitalization." However, neither court attempted a legal definition of the term "recapitalization" as applicable to the facts in the instant case.

Since every stock dividend necessarily involves a change in capital of one kind or another, it necessarily also involves a recapitalization in one sense or another. But under the *Koshland* and *Gowran* cases it is not every recapitalization that will avoid the taxability of a stock dividend to the recipients.

If the contrary were true no stock dividend payable in the stock of the corporation owing the dividend could ever be taxable because every such stock dividend involves a recapitalization in some sense.

The foregoing is not inconsistent with the decisions of this Court holding stock dividends non-taxable where, as in *Helvering* v. *Griffiths,* 318 U. S. 371, there was a stock dividend payable in common stock to a common stockholder; or where as in *Strassburger* v. *Commissioner,* 318 U. S. 604, there was a stock dividend, so-called, payable in preferred stock to the sole holder of all of the common stock.

In each of the cases just mentioned "the proportionate interest of the stockholder after the distribution was" *not* "essentially different from his former interest". In the case at bar the preferred stockholders were in almost all cases wholly different persons from the common stockholders and, wherever they were the same persons, they held preferred stock in different proportions from their holdings of common stock.

While no adjudicated case has involved the taxability of a stock dividend paid to preferred stockholders in preferred stock, the taxability of such a dividend is supported by such writers as Mertens (Law of Federal Income Taxation, Vol. 1, page 641) and Magill (Taxable Income, 1936 Edition, page 48).

Dividends on the preferred stock may not be paid in any medium other than cash except with the consent in each instance of each individual stockholder. Such consent was obtained in the instant case from practically 100% of the 7% stockholders. The payment of accumulated arrears of dividends in stock, pursuant to such necessary consent, was not a recapitalization within any logical definition of that term as used and intended by Congress in its legislation relative to non-taxable reorganizations. And neither the Tax Court nor the Third Circuit offered any definition of the term which would make a stock dividend non-taxable under the facts of this case.

The question when a stock dividend, paid in preferred stock to preferred stockholders, does or does not "alter the proportionate interest of the stockholder" so as to be taxable or non-taxable, is of sufficient importance to merit consideration and decision thereof by this Court, the precise question never having been heretofore passed upon by it.

The petitioner deems it highly important and a matter of public interest that this Court decide whether a stock dividend otherwise taxable shall avoid taxability because the declaration and payment of the dividend is the whole,

or even a part, of a transaction which may be termed recapitalization in some sense or other.

II. The decision herein is in conflict with other decisions of the Third Circuit and of the Tax Court now pending before this Court on applications for writs of certiorari.

In the cases of *Bazley, supra,* and *Adams, supra,* the Third Circuit by a divided court *en banc* determined that the stock dividends in those cases were taxable to the stockholders because the purpose thereof was to benefit the stockholders as distinguished from a corporate business purpose. In the instant case the petitioner contends that the primary purpose of the stock dividend here involved was to benefit not only the 7 per cent preferred stock but the common stockholders as well, because only by such means was it possible for the corporation, in its then financial state, to resume the payment of dividends on the common stock and thereafter to pay dividends on the new 6 per cent preferred. However, as stated already, neither the Tax Court nor the Third Circuit made any finding of fact as to whether such payment of a stock dividend, in this case, was for the benefit of the stockholders or of the corporation.

It would seem axiomatic, however, that any payment of a dividend, whether in cash or in stock, and whether or not such payment was necessary to the future resumption of cash dividends, must be for the benefit of the stockholders. It could not benefit the corporation unless perhaps incidentally.

The record shows that since the transaction here involved and the discharge by the corporation of its obligation with respect to the accumulated arrears of dividends on the 7 per cent stock by the payment thereof in 6 per cent stock, the payment of cash dividends was resumed and has continued to the present time.

Many of the former holders of the 7 per cent stock reside within the Third Circuit. Income taxes were collected

from them on account of this stock dividend pursuant to a ruling by the Commissioner that the stock dividend was taxable to them. If this stock dividend is now held non-taxable all of these stockholders should be entitled to recover the taxes so paid with respect thereto. If the Tax Court and the Third Circuit are reversed on this point numerous actions by such stockholders for the recovery of the taxes so paid may be avoided.

III. The decision herein by the courts below is in conflict with applicable decisions of this Court.

In *Koshland* v. *Helvering, supra,* and *Helvering* v. *Gowran, supra,* this Court held stock dividends to be taxable to the recipients where they received thereby a proportionate interest essentially different from their former interest. Inconsistently with and in contravention of those decisions the lower courts have held this stock dividend non-taxable merely because the transaction with which it was connected or with which it was simultaneous or concurrent was a recapitalization in some sense not defined by either Court.

Unless this issue of the taxability or non-taxability of a stock dividend in connection with a recapitalization is clarified by this Court, every sort and kind of stock dividend otherwise taxable can avoid taxation by the simple device of involving it with some kind of recapitalization. This result would be not only a repudiation of the decisions of this Court in the *Koshland* and *Gowran* cases, but it would defeat the clear intention of Congress, as expressed

in all Revenue Laws since 1936, that all stock dividends shall be taxed to the extent that they constitute income under the amendment to the Constitution.

And your petitioner will ever pray, etc.

THE OKONITE COMPANY,
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